[As corrected April 5, 1967]

No. 21,146

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

v.

NATIONAL SECURITIES, INC., a corporation, NATIONAL LIFE & CASUALTY INSURANCE COMPANY, a corporation, ROBERT A. WALLACE, ROBERT C. BOHANNAN, JR., ARTHUR W. SAFFERT, TED WILKINS, JOHN S. BARRETT, JOSEPH B. SETTER, BREEFERD W. LARGE, JR. and PRODUCERS LIFE INSURANCE COMPANY, a corporation (also known as NATIONAL PRODUCERS LIFE INSURANCE COMPANY),

Defendants-Appellees.

APPEAL FROM UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ARIZONA (Phoenix Division)

REPLY BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF-APPELLANT

FILED

APR 7 1967

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I. THE CONSOLIDATION OF PRODUCERS LIFE INSURANCE COMPANY AND NATIONAL LIFE AND CASUALTY INSURANCE COMPANY INVOLVED PURCHASES AND SALES OF SECURITIES WITHIN THE MEANING OF SECTION 10(b) OF THE SECURITIES EXCHANGE ACT AND RULE 10b-5.

The district court did not reach the question whether the consolidation of Producers Life and National Life into National

Producers involved purchases or sales of securities in connection with which the alleged fraud occurred. Appellees nevertheless contend (Br 29) that "unless a statutory merger is a 'purchase or sale' within the meaning of Rule 10b-5, that section has no application to the instant case at all." This argument wholly ignores the fraud alleged in the purchase by appellees of the treasury stock of Producers Life. 1/

On the merits, appellees ignore the broad definitions of the terms "purchase" and "sale" in the Securities Exchange Act of 1934 and

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1/ Appellees contend (Br 46-47) that no question was presented to the district court involving defendants' violations of Section 10(b) and Rule 10b-5 in connection with National Securities' purchase of Producers Life's treasury stock. The Commission's original complaint (R. 6, ¶¶5,6) and its Amended and Supplemental Complaint (R. 428, ¶5) both set forth with particularity the facts concerning National Securities' purchase of the Producers Life treasury stock as part of its allegation that defendants' acts and practices constituted an unlawful scheme to defraud Producers Life and its stockholders (R. 3, 425).

In any event, as appellees recognize (Br 30), the district court did not purport to decide all of the issues in the case but disposed of it solely on the ground that the application of the antifraud provisions of the Securities Exchange Act was precluded by the McCarran Act and that certain of the relief sought by the Commission was unavailable to it. Accordingly, the rationale underlying the decisions of this Court cited by appellees (Br 47) does not apply. As pointed out in Stephens v. Arrow Lumber Co., 354 F. 2d 732, 734 (1966) and Partenweederei, MS Belgrano v. Weigel 313 F. 2d 423, 425 (1962), certiorari denied, 373 U.S. 904 (1963), the policy requiring that contentions not be raised for the first time on appeal is to provide this Court with "the benefit of the district court's wisdom" on the issues raised. This consideration is inapplicable where the case is disposed of on other issues. Indeed, the very rationale of those decisions of "preventing piecemeal litigation and consequent waste of the time of both trial and appellate courts" seems to require that all of the dispositive legal issues be herein decided.

the necessity that these terms not be so narrowly construed that investors would be deprived of the protections Congress intended them to have. (See pp. 22-28 of our opening brief.) They rely in large part (Br 33-35) upon the position taken by the Commission in an amicus curiae brief filed in this Court almost 25 years ago in National Supply Co. v. Leland Stanford Jr. University, 134 F. 2d 689, involving the definition of "sale" in the Securities Act of 1933 and upon this Court's summary agreement therewith in that case as an alternative ground for its reversal of the judgment of the district court. They point to superficial distinctions in the district court decisions contrary to their position [2/] and of the district court cases on which they rely, one has since been reversed (Br 40).

2/ As cited at page 28 of our opening brief, these were Simon v. New Haven Board and Carton Co., 250 F. Supp. 297 (D. Conn., 1966); Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369 (D. Del., 1965); and the unreported case of Securities and Exchange Commission v. Anaconda Lead & Silver Co. (D. Colo., No. 6189, July 11, 1961).

Despite appellees' attempted distinction, it is clear that the Simon case involved a merger which the plaintiff therein contended "was authorized by the shareholders of New Haven on the basis of falsified and misleading reports and proxy statements . . . ." 250 F. Supp. at 298. Accordingly, the case appears to be on all fours with the instant case and we do not understand appellees' attempted distinction any more than we understand their reference in the discussion of that case to the New Haven Railroad (Br 40), which was not involved therein.

Appellees also suggest that the Voege case "is not in the real sense a merger" (Br 40), but the fraud alleged was in bringing about a merger of one corporation into another, resulting in the forced surrender of the plaintiff's stock in the merged corporation at less than its real value, 241 F. Supp. at 372, 375-376. As noted in the text, infra, pp. 6-7, with respect to Vine v. Beneficial Finance Co., the basis of the "no sale theory" relied on by appellees in this case is the same as that which would underlie the contention that there is "no sale" in the type of short form merger involved in Voege.

Appellees do not refer to Securities and Exchange Commission v. Anaconda Lead & Silver Co., but instead purport to distinguish Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D. N.Y., 1965), a case not cited in our opening brief.

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Appellees do not refer to Securities and Exchange Commission v. Anaconda Lead & Silver Co., but instead purport to distinguish Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D. N.Y., 1965), a case not cited in our opening brief.

Subsequent to the filing of appellees' brief, the United States Court of Appeals for the Second Circuit, on March 13, 1967, reversed Vine v. Beneficial Finance Co., 252 F. Supp. 212 (S.D. N.Y., 1966), referred to at page 28 in our opening brief and in appellees' brief at pages 39-40. Vine v. Beneficial Finance Co., CCH Fed. Sec. L. Rep. ¶ 91,906.[3/] In that case the plaintiff-appellant, a stockholder of Crown Finance Company, Inc., alleged that officers and directors of that corporation conspired to merge it into Beneficial Finance Co. at the expense of Crown shareholders and for the benefit of the former Crown directors and of Beneficial. The scheme was accomplished by the purchase of Crown stock by Beneficial from the directors of Crown; by a public offer of Beneficial to purchase Crown stock, without disclosing material facts; and, sufficient stock having been thus acquired by Beneficial, by a short form merger of Crown into Beneficial. The plaintiff-appellant had not tendered his shares in response to Beneficial's offer, but after the short form merger he had "only the options of exchanging his stock for $3.29 a share, pursuant to appellee's offer, or pursuing his right of appraisal, which would also result in cash from appellee" (Slip Op. 1540). The question was whether the plaintiff-appellant was a seller of securities within the meaning of Section 10(b) of the Securities Exchange Act and Rule 10b-5.

As stated by the Court of Appeals, the district court held "that since Vine neither accepted the offer to purchase his stock nor surrendered

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3/ The Slip Opinion is reproduced in the Appendix to this brief except for the portions of the opinion numbered "II", dealing with the question whether the notice of appeal was timely filed; numbered "IV", dealing with the question of whether an amended complaint should have been permitted to be filed; and numbered "V", dealing with the question as to the propriety of derivative and class actions.

his stock pursuant to the statutory short form merger, he was not a seller, and therefore there could have been no fraud as to him in connection with the purchase or sale of a security" (Slip Op. 1538). The Court of Appeals disagreed with this "narrow holding" (ibid.), stating (Slip Op. 1541):

> "Since, in order to realize any value for his stock, appellant must exchange the shares for money from appellee, as a practical matter appellant must eventually become a party to a 'sale,' as that term has always been used."

It held that plaintiff-appellant was a "seller" under the Securities Exchange Act (Slip Op. 1542), noting that the various transactions were "all part of a single fraudulent scheme," which was "a classic example of deception of an entire class of . . . stockholders" within the reach of Section 10(b) and Rule 10b-5 (Slip Op. 1543). 4/

4/ In the instant case appellees ask this Court to look separately at each aspect of the fraud (Br 26-27, 47-48). Whether or not the purchase of stock from the selling directors of Producers Life, the purchase of Producers Life treasury stock, the agreement whereby National Securities was to manage Producers Life, or the transfer of shares of Producers Life by National Securities to National Life would separately constitute a violation of Rule 10b-5, these activities together, as "part of a single fraudulent scheme," as alleged, are an "example of deception" of the public security holders of Producers Life. Whether or not the scheme in the instant case is a "classic" or novel fraud is, of course, not determinative. The Court of Appeals for the Second Circuit stated in a decision just handed down:

> "We believe that §10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

A. T. Brod & Co. v. Perlow, ___ F. 2d ___ (C.A. 2, No. 31028, March 27, 1967).

Thus in the first appellate holding as to the application to a merger of Rule 10b-5 (and the first appellate discussion involving the application to a merger of the antifraud provisions of the federal securities laws since Leland Stanford), it is squarely held that a merger involves a purchase and sale of securities within the meaning of the Securities Exchange Act. In reaching this result, the Court of Appeals in Vine noted that "whatever stance [the Commission] . . . adopted two decades ago" in the Leland Stanford case, in Vine it strongly urged that the merger involved "resulted in a purchase and sale of plaintiff's stock within the meaning of Rule 10b-5" (Slip Op. 1545).

The Court of Appeals also noted in Vine that the appellee in that case vigorously contended that the plaintiff could not be "a defrauded seller because nothing was asked of him, no representations were made to him--indeed, under the merger statute, nothing had to be communicated to him but notice of his right to the offered $3.29 or to demand an appraisal" (Slip Op. 1543). This contention is comparable to appellees' argument here (Br 34, 36), incorporated by reference from the Commission' brief in Leland Stanford, that there is no sale in a merger because "the alteration of the stockholder's security occurs not because he

consents to an exchange, but because the corporation by authorized corporate action converts his security from one form to another."

As we have seen, the Court of Appeals in Vine held that even though the plaintiff still had his stock certificate in Crown he should nonetheless be deemed a seller. We submit that this realistic position should also be applied here, even though appellees point out (Br 32) that a former Producers Life stockholder is not required to exchange his stock certificate and can retain the "piece of paper" representing his shares in Producers Life.

Appellees also suggest (Br 32) that somehow Rule 10b-5 is not applicable here because the consolidation occurred under Arizona law and had to be approved by the State Director of Insurance, but, as noted by the Court of Appeals in Vine, citing J.I. Case Co. v. Borak, 377 U.S. 426, 433-435 (1964), "the existence of a state remedy" cannot, even in a private action, negate a federal right (Slip Op. 1544-1545). Certainly in an enforcement action by a federal agency, charged with administering a law for which violations can be prosecuted only in the federal courts,[5/] a possible state remedy is irrelevant.

5/ See Section 27 of the Securities Exchange Act, 15 U.S.C. 78aa.

II. APPELLEES HAVE NOT SHOWN THAT THE McCARRAN ACT PRECLUDES THE APPLICATION OF THE ANTIFRAUD PROVISIONS OF THE SECURITIES EXCHANGE ACT AND RULE 10b-5 TO SALES AND PURCHASES OF SECURITIES INVOLVED IN A CONSOLIDATION OF INSURANCE COMPANIES APPROVED BY A STATE INSURANCE OFFICIAL.

Appellees do not express disagreement with United States v. Sylvanus 192 F.2d 96 (C.A. 7, 1951), holding that the federal mail fraud statute is applicable to the sale of securities of insurance companies, and with reference thereto they concede (Br 26) that "[t]he McCarran Act may permit supplemental or ancillary or additional Federal regulation which somehow relates to insurance . . . ." They suggest, inconsistently, that such ancillary regulation does not occur with respect to fraud in connection with the transfer of insurance company stock in violation of the Securities Exchange Act. For reasons set out in our opening brief (pp. 16-17) it is clear that the McCarran Act, which was enacted to preserve state authority over the "business of insurance", does not and was not intended to limit the federal laws dealing with transactions in securities.

The McCarran Act, as we pointed out in our opening brief (p. 13), was adopted in response to a Supreme Court decision that the antitrust laws were applicable to insurance companies. Section 2(b) of that Act, 15 U.S.C. 1012(b), limited the application of the antitrust laws and the Federal Trade Commission Act to insurance companies in those states where laws regulating the business of insurance were not adopted. All but one of the cases relied upon by appellees (Br 23-26) involved the question whether the antitrust laws or Federal Trade Commission Act should be applicable or whether "the business of insurance" was "regulated by State law" within the meaning of the McCarran Act. The remaining case, Zachman v. Erwin,

186 F. Supp. 691 (S.D. Tex., 1960), holds that the antifraud provisions of the Securities Act of 1933 are applicable in an action to rescind the purchase of a Texas insurance company's securities. By referring to the fact that "the Insurance Code of Texas" revealed "no special remedy for purchasers against persons who have defrauded them in the sale of insurance company securities" (186 F. Supp. at 694), the court could well have been emphasizing the need for the application of the Securities Act without in any way implying, as appellees contend (Br 24), that, were there such a remedy in the Texas statute, the Securities Act would have been "superseded."

Appellees also suggest (Br 26-29) that the application of the antifraud provisions of the Securities Exchange Act to the instant case would obliterate the functions of the Arizona Director of Insurance. Even if the state statute should specifically give the Director power to pass upon the question whether there is fraud in transactions in securities of insurance companies, such a provision should not remove these transactions from the scope of the federal securities laws. Compare, Securities and Exchange Commission v. Variable Annuity Life Insurance Co., 359 U.S. 65, 69 (1959); and Prudential Insurance Co. v. Securities and Exchange Commission, 326 F. 2d 383, 388 (C.A. 3, 1964).[6/] The Commission's

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6/ The frivolous nature of appellees' argument appears from their contention (Br 49) that the Commission should have appealed from the decision of the Arizona Director of Insurance approving the merger. Section 21(e) of the Securities Exchange Act, 15 U.S.C. 78u(e), provides that "[w]henever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions . . ." of the Act or rules thereunder, "it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices . . . ." And Section 27 of the Act gives exclusive jurisdiction to the federal courts over violations of the Act and rules thereunder.

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action in no way impinges upon the power of the Arizona Director of Insurance to regulate the business of insurance in the State of Arizona. It merely attempts to enforce the antifraud provisions of the Securities Exchange Act in connection with purchases and sales of insurance company securities.

III. THE POWERS OF THE COMMISSION TO REGULATE THE PROXY SOLICITING MATERIAL OF SOME CORPORATIONS GRANTED BY SECTION 14(a) OF THE SECURITIES EXCHANGE ACT DO NOT PRECLUDE THE APPLICATION OF SECTION 10(b) OF THE ACT AND RULE 10b-5 TO SECURITIES TRANSACTIONS INDUCED BY FRAUDULENT PROXY STATEMENTS.

Appellees recognize (Br 41) that in enacting the Securities Exchange Act Congress gave the Commission "a mighty arsenal of weapons" and that all of these "weapons" are not contained "in any one section or in any one rule." They contend (Br 41-46), however, that Section 10(b) of the Act cannot apply to fraudulent proxy solicitations because Section 14(a) of the Act, 15 U.S.C. 78n(a), gives the Commission specific powers over the proxy solicitations of some companies. 7/ In effect, appellees ask this Court to hold that the Commission is powerless to seek to enjoin fraudulent representations designed to induce persons to sell or purchase securities of those companies which

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7/ Appellees also contend (Br 44) that the district court disposed of this issue in its opinion and that, since the Commission has not contested this determination, the appeal should be dismissed. But Judge Mathes (R. 797-798) stated in this regard only that Section 14 was not applicable--a statement with which we agree. He decided the case on the assumption that Section 10(b) may be applicable to proxy solicitation material--an assumption with which we agree (R. 798). Accordingly, there was no question in this regard for the Commission to raise on appeal.

are not subject to the Commission's proxy rules, so long as the fraudulent representations are confined to proxy statements. Congress could not have intended this result in a statute designed to make "transactions in securities . . . reasonably complete and effective." Section 2 of the Act, 15 U.S.C. 78b. 8/

It is not uncommon for securities frauds to involve a violation of the provisions of several sections of the securities laws or rules promulgated by the Commission, for neither Congress nor the Commission has been primarily concerned with categorizing securities frauds into neat pigeonholes; rather their concern has been with preventing unfair and inequitable practices in securities transactions. For example, a fraud committed on a purchaser or seller of securities by a broker-dealer would violate Section 15(c) of the Securities Exchange Act, 15 U.S.C. 78o(c), as well as Section 10(b) and Rule 10b-5--and also, in the case of a purchaser, Section 17(a) of the Securities Act, 15 U.S.C. 77q(a). Similarly, a manipulation of securities might violate Section 9(a) of the Securities Exchange Act, 15 U.S.C. 78i(a), and the antifraud provisions cited above. This Court has held that defrauded purchasers

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8/ The court below referred to the unreported district court decision in Borak v. J. I. Case Co., (E.D. Wis., No. 56 C247, 1962), which had dismissed a complaint alleging violations of both the Commission's proxy rules and Rule 10b-5. The Court of Appeals, in reversing the order dismissing the complaint, held that Section 10(b) had no application to the facts alleged in the complaint but specifically stated that it expressed "no opinion" on the question "whether misleading proxy material may, under any circumstances, constitute a manipulative and deceptive device within the prohibition of that Section," Borak v. J. I. Case Co., 317 F. 2d 838, 847 (C.A. 7, 1963), aff'd on other grounds, 377 U.S. 426 (1964).

of securities have an implied right of action under Section 10(b) of the Securities Exchange Act, despite the fact that Congress specifically made available to such purchasers certain civil remedies in Sections 11 and 12 of the Securities Act, 15 U.S.C. 77k and _l_. _Matheson_ v. _Armbrust_, 284 F. 2d 670 (1960), _certiorari denied_, 365 U.S. 870 (1961); _Ellis_ v. _Carter_, 291 F. 2d 270 (1961).

The argument is comparable to urging that Section 10(b) and Rule 10b-5 do not apply to transactions in securities by corporate insiders because specific provisions relating to securities transactions by insiders of certain corporations are found in Section 16 of the Act.[9/] The activities of insiders, however, have repeatedly been found to be subject to Section 10(b) and Rule 10b-5.[10/] Indeed, the theory advanced by

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9/ Section 16, _inter alia_, provides for the reporting of the transactions in equity securities by officers, directors and certain large security holders of corporations listed on exchanges and certain other widely-held corporations and provides that any such person who purchases and sells (or sells and purchases) the equity securities of his corporation within a six-month period shall be liable to the corporation for his profits.

10/ _List_ v. _Fashion Park, Inc._, 340 F. 2d 457, 461-462 (C.A. 2), _certiorari denied_, 382 U.S. 811 (1965); _Kohler_ v. _Kohler Co._, 319 F. 2d 634, 638 (C.A. 7, 1963); _Reed_ v. _Riddle Airlines_, 266 F. 2d 314 (C.A. 5, 1959); _Cochran_ v. _Channing Corp._, 211 F. Supp. 239, 242-243 (S.D. N.Y., 1962); _Speed_ v. _Transamerica Corp._, 99 F. Supp. 808, 828-829 (D. Del., 1951), _final judgment awarded_, 135 F. Supp. 176, 186-187 (D. Del., 1955), _aff'd as modified_, 235 F. 2d 369 (C.A. 3, 1956); _Kardon_ v. _National Gypsum Co._, 73 F. Supp. 798 (E.D. Pa.), _modified in other respects_, 83 F. Supp. 613 (E.D. Pa., 1947); _Securities and Exchange Commission_ v. _Texas Gulf Sulphur Co._, 258 F. Supp. 262, 278 (S.D. N.Y., 1966), _appeal pending_ (C.A. 2); _Mansfield Hardware Lumber Co._ v. _Johnson_, 268 F. 2d 317, 319 n.3 (C.A. 5) (dictum), _certiorari denied_, 361 U.S. 885 (1959). _Cf_. _Securities and Exchange Commission_ v. _Chenery Corp._, 318 U.S. 80, 9 (1943).

appellees, if pressed to its logical conclusion, would lead to the absurdity that the antifraud provisions of the Securities Act and of the Securities Exchange Act are not to be applied to any sales of securities, since it could be argued that securities sales are dealt with under Section 5 of the Securities Act, 15 U.S.C. 77e, which requires the registration of non-exempt securities offerings.

Appellees' argument also misconceives important differences between Sections 14(a) and 10(b). Section 14(a) makes it unlawful to solicit proxies in contravention of rules adopted by the Commission. Proxies may be sought for such matters as the election of directors, selection of auditors, sales of substantial assets or amendments to bylaws, or for matters involving the purchase or sale of securities, such as the issuance of stock options or the approval of a proposed merger. Section 10(b) of the Act on the other hand permits the Commission to adopt rules precluding manipulative or deceptive devices only "in connection with the purchase or sale of any security." The Commission would be unable to adopt rules under Section 10(b) relating to proxies not involving "the purchase or sale of any security." Thus the Commission was not "disingenuous," as appellees suggest (Br 45-46), in urging the 1964 amendment to the Securities Exchange Act which gave it authority to regulate the proxy solicitation of certain widely-held companies not previously subject to the proxy rules.

Moreover, the quantum of disclosure under Section 14(a) of the Act and the proxy rules is different from that required by Section 10(b).

Pursuant to Section 14 the Commission has adopted a comprehensive set of rules governing proxies and a detailed schedule of information to be included in proxy statements. See Rules 14a-1 through 14a-12, 17 CFR 240.14a-1 through 14a-12; Schedule 14A. To avoid violation of Section 10(b), however, pursuant to which no specific items of disclosure are required, disclosure which does not include everything required in a proxy statement may be adequate.

IV. THE ISSUE OF INDISPENSABLE PARTIES IS NOT PROPERLY BEFORE THIS COURT.

Defendants contend (Br 17-21) that the former directors of Producers Life who sold their Producers Life stock to National Securities ("selling directors") are indispensable parties to this action and that for want of their joinder, the action should be dismissed.[11/] This issue, we submit, is not properly before this Court.

The question of the indispensability of the selling directors as parties, as appellees recognize (Br 17), goes to the question of the relief sought. The refusal of courts to grant relief when indispensable parties have not been joined is derived from an old equity practice designed to afford complete relief in an action. See State of Washington v. United States, 87 F. 2d 421 (C.A. 9, 1936). As this Court recognized in that case (87 F. 2d at 427), the failure to join indispensable parties is not jurisdictional, especially in an action under a federal statute not based on diversity of citizenship. See 3 Moore's Federal Practice ¶19.05.

11/ In view of the fact that the appellees (R. 507-509) opposed the Commission's motion to rename the selling directors of Producers Life as defendants, it comes with ill grace for them to now assert before this Court that the selling directors of Producers Life were indispensable parties.

The question of indispensable parties will not arise in the instant case if the district court in its discretion should frame a decree which would not affect any interest of the selling directors. For example, if an injunction which prohibited future violations were entered against only the appellees, the present defendants, this would have no effect upon the selling directors of Producers Life, and appellees have no standing to complain that the Commission may not have named as a defendant every person who may have been a party to appellees' scheme.

Upon remand the Commission could seek to amend its complaint to eliminate any relief to the extent that such relief might be deemed to affect the interests of the selling directors of Producers Life; or, if this Court should agree with the Commission that appellees' conduct constituted a scheme to defraud in violation of Rule 10b-5, the Commission could again seek to amend its complaint to include the selling directors of Producers Life.[12/]

12/ The district court denied the Commission's motion to add the selling directors of Producers Life as defendants, stating:

> "[A]nd it appearing to the Court that, while there may be actionable claims against some of the proposed additional defendants for alleged breaches of fiduciary duty under the laws of Arizona, the Securities and Exchange Commission has not asserted, and cannot assert under any Federal statute which the Commission is charged with the duty to enforce, a cause of action against these proposed defendants [see: O'Neill v. Maytag, 339 F. 2d 76 (2nd Cir. 1964); Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (2nd Cir. 1961)] . . . ." (R. 793-794.)

Should this Court find that the appellees' alleged conduct violated Rule 10b-5, the district court might wish to reconsider

(continued)

CONCLUSION

For the foregoing reasons and for the reasons set forth in our opening brief, the judgment of the district court should be vacated and the case remanded to that court for further proceedings.

Respectfully submitted,

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March 1967

12/ (continued)

whether the conduct of their co-schemers was not also a violation of that provision. The doctrine of law of the case would not seem to preclude it from doing so. See Messenger v. Anderson, 225 U.S. 436, 444 (1912).

On the other hand, if the district court was correct in denying the motion to add the selling directors of Producers Life as defendants for the reasons it stated, then those persons are not indispensable parties.

CERTIFICATE

I certify that, in connection with the preparation of this brief, as corrected, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

David Ferber
Solicitor

April 5, 1967

APPENDIX

Portions of the Slip Opinion of the United States Court of Appeals for the Second Circuit in Vine v. Beneficial Finance Co. (No. 30500, March 13, 1967)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 67—September Term, 1966.

(Argued October 6, 1966 Decided March 13, 1967.)

Docket No. 30500

LEO VINE,

Plaintiff-Appellant,

—against—

BENEFICIAL FINANCE COMPANY, INC.,

Defendant-Appellee,

—and—

CHARLES H. DOWD, STUART A. WIXSON, GEORGE J. SPRINGER, C. H. DONOHUE and CROWN FINANCE COMPANY, INC.,

Defendants.

Before:

SMITH, HAYS and FEINBERG,

Circuit Judges.

Appeal from orders of the United States District Court for the Southern District of New York, Dudley B. Bonsal, *J.*, dismissing a complaint under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission, 252 F. Supp. 212, and denying leave to file a second amended complaint. The first order is reversed in part; the second is affirmed.

Lawrence M. Powers, New York, N. Y. (Berman & Powers, Ira W. Berman, on the brief), *for Plaintiff-Appellant.*

Wilkie Bushby, New York, N. Y. (Dewey, Ballantine, Bushby, Palmer & Wood, Joseph Schreiber, Robert I. Fisher, on the brief), *for Appellee.*

Philip A. Loomis, Jr., General Counsel; David Ferber, Solicitor; Roy Nerenberg, Attorney; Securities and Exchange Commission, Washington, D. C., as *amicus curiae,* urging reversal.

Feinberg, *Circuit Judge*:

This is another of the growing number of cases based upon section 10(b) of the Securities Exchange Act of 1934 ("the Act"), and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission. We deal primarily with the first amended complaint of appellant Leo Vine against appellee Beneficial Finance Company, Inc., which alleges violations of both the Act and state law. The District Court for the Southern District of New York dismissed the complaint. Its basic holding was narrow; the federal action failed because Vine was not a "seller" of securities. For reasons elaborated below, we hold that Vine is entitled to invoke the Act, and reverse the order of dismissal.

I.

The amended complaint alleges: Vine, a resident of New York, has owned during all relevant times 100 shares of Class A common stock of Crown Finance Company, Inc., a

Delaware corporation with its principal office in Delaware, as is Beneficial. Beneficial and Crown both are in the business of operating small loan offices. The stock of the former, with over a billion dollars in assets, is listed on the New York Stock Exchange; Crown, a much smaller company, has limited over-the-counter trading in its stock. Crown has two classes of common stock, A and B, with equal voting rights except that A designates one-third of the directors and B, two-thirds. In liquidation, a B share equals only one-tenth of an A share, and A has a claim on eighty per cent of sums set aside for payment of cash dividends at any time, while the B stockholders have twenty per cent. There were 624,870 A shares outstanding at the relevant times, and 46,500 B shares outstanding. The officers and directors of Crown were its principal Class B stockholders. Vine's claim is that Beneficial, acting in concert with these officers and directors and using means and instrumentalities of interstate commerce and the mails, defrauded Crown and its Class A stockholders by appropriating for Class B stockholders $900,000 which otherwise would have gone to Class A stockholders, and by merging Crown into Beneficial for at least $800,000 less than the fair market value of Crown.

The complaint describes the mechanics of the fraudulent scheme as follows: While negotiating for the acquisition of Crown in the spring and summer of 1963, Beneficial desired to merge Crown into Beneficial at a cost equal to Crown's book net worth, which in June was about $1,680,000, exclusive of good will. Knowing Beneficial's wishes in the matter, Crown's officers and directors[1] conspired with Beneficial to divert to themselves more than a fair share of the price to be paid for Crown. Although

1 Named as defendants, but only Beneficial was served.

these individuals were minority stockholders, they controlled the board of directors. If Beneficial had acted as it should have (according to Vine) and offered in a merger to give all Crown stockholders cash for their stock, or to buy Crown's assets for cash, A stockholders would have voted share for share alike with B stockholders. A's voting superiority would have prevented a merger or sale of assets giving grossly disproportionate proceeds to the B class, since either plan would require two-thirds approval of all stockholders. Even if the total price had remained the same, the Class A stockholders would then have received about $1,670,000, and Class B, only $12,500, the book value of the stock at the time. But using their fiduciary positions, the Class B stockholders "shape[d] the transaction in such a way" that they were paid about $700,000 for their shares, plus some $200,000 in benefits under employment and consulting agreements. Class A stockholders were paid only $800,000 for their stock, $870,000 less than they should have received. Moreover, but for the fraudulent scheme, Beneficial would have had to pay more than mere book net worth. Beneficial's motive in the conspiracy was to keep the cost of the acquisition down by overpaying the B's and underpaying the A's; Beneficial received at least $300,000 in tangible assets and $500,000 worth of going business value without paying for them.

In sum, in the words of the district judge, "the alleged fraudulent scheme involved three steps: (1) a purchase by Beneficial of the Class B stock from the directors of Crown; (2) a public offer or tender by Beneficial to the holders of the Class A stock to acquire 95% of the total outstanding shares of Crown; and (3) a short form merger of Crown into a wholly-owned New York subsidiary of

Beneficial which would result in the acquisition of the remaining shares of Class A stock." Thus, the complaint alleges that in early August 1963, Beneficial agreed with the principal B stockholders to buy their 43,000 shares at $15.00 a share, and later that month made a public offer to A stockholders to purchase A shares for $1.25 a share. This was increased to $2.50 in an offer sent out to remaining A holders in January 1965. Some A holders accepted, not knowing the facts. By the fall of 1965, having acquired ninety-five per cent of the A stock, Beneficial was engaged in completing the merger of Crown into it on a basis which paid minority stockholders $3.29 in cash per share; since this was a short form merger, the assent of the remaining A stockholders, like appellant Vine, was not necessary. The complaint further alleges that this overall scheme and the various acts and omissions pursuant thereto constituted fraud on the Class A stockholders and were violations of the Act and Rule 10b-5, and New York and Delaware law. The amended complaint seeks $1,700,000 in damages for Crown, plus what Crown's assets were worth in addition to what was paid for them, and punitive damages, all to be paid pro rata to A stockholders who did not participate in the claimed wrongdoing.

* * * * *

III.

Turning to the merits, we consider first the amended complaint's federal claim under the Act and Rule; the factual allegations in the complaint must, of course, be taken as true, since judgment was granted on a motion to dismiss. The district court's narrow holding was that since Vine neither accepted the offer to purchase his stock nor surrendered his stock pursuant to the statutory short form merger, he was not a seller, and therefore there could have been no fraud as to him in connection with the purchase or sale of a security.

Section 10 of the Act, 15 U. S. C. §78j, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national

> securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Commission, 17 C. F. R. §240.10b-5 (1964), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Although the complaint was properly characterized by the district judge as "diffuse," it does allege a "scheme . . . to defraud" and a "course of business which . . . would operate as a fraud" within subsections (a) and (c) of the Rule.[5] In this court, therefore, the narrow question is once again whether appellant is a seller, both parties assuming that *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (2d Cir.),

5 A violation of subsection (b) is also alleged in general terms.

cert. denied, 343 U. S. 956 (1952), requires this status for him.[6] Appellee claims that Vine is not a seller; appellant argues that he is indeed a seller, albeit a forced one, as a result of the short form merger.

Appellant's position is controlled by the mechanics of a short form merger. It is unclear whether the merger was carried out under Delaware or New York law, but the respective statutes are similar enough. New York Business Corporation Law §905(a) authorizes a corporation owning at least ninety-five per cent of the outstanding shares of each class of another corporation to merge the latter corporation into the former without the authorization of the shareholders of the latter corporation, on approval of the board of the former corporation (see §907(c) for foreign corporations). Under Delaware Code Ann. tit. 8, §253(a) (Supp. 1964), the surviving corporation need only own ninety per cent of the subsidiary. The consent of the remaining five per cent (or ten per cent) stockholders is not required to effectuate a short form merger. However, such stockholders are given an opportunity to obtain the fair value of their shares, either by agreement with the corporation (presumably this is the source of the $3.29 figure alleged by appellant) or by a judicial proceeding—the so-called "appraisal." See generally Israels, Corporate Practice 283-98 (1963); Note, *Valuation of Dissenters' Stock Under Appraisal Statutes,* 79 Harv. L. Rev. 1453 (1966).

Thus, once the conditions for a short form merger had been achieved, appellant's rights in his stock were frozen. He had and still has only the options of exchanging his stock for $3.29 a share, pursuant to appellee's offer, or pursuing his right of appraisal, which would also result in cash from appellee. Other than that, with one possible exception to be

6 An alternative suggestion of *amicus* Securities and Exchange Commission argues for a broader reading of the law, discussed below.

discussed below, appellant is left only with certificates of ownership in a non-existent corporation. Since, in order to realize any value for his stock, appellant must exchange the shares for money from appellee, as a practical matter appellant must eventually become a party to a "sale," as that term has always been used. See 1 Corbin, Contracts §4 (1963). It is true that appellant still has his stock; if he turned it in for the price of $3.29 a share, it would be clearer that appellant is a seller. Assuming that this would not otherwise affect his right to sue under the Act and the Rule, requiring him to do so as a condition to suit seems a needless formality.

We do not construe the Act so narrowly. As noted above, section 10(b) of the Act applies to the "purchase or sale" of securities. Section 3 of the Act, 15 U. S. C. §78c, provides:

> (a) When used in this title, unless the context otherwise requires—
>
> *   *   *   *   *
>
> (13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.
>
> (14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.

It has been pointed out that the verb "include," rather than the verb "means," emphasizes the breadth of this definition, see *United States* v. *Robertson,* 181 F. Supp. 158, 162 (S. D. N. Y. 1959) (construing similar language in the Securities Act of 1933), and the phrases "or otherwise acquire" and "or otherwise dispose of" are hardly limiting. We do not have here a stockholder who refuses to accept a fraudulent offer to purchase his stock but remains a stockholder in an existing corporation; whether

to label this hypothetical person a "seller" under the Rule is a much different question. Due to defendant's acts, Crown has now disappeared and plaintiff's stock has, in effect, been involuntarily converted into a claim for cash. The only case cited to us on all fours is *Voege* v. *American Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965), in which the court concluded, although on a different theory from the one adopted here, that a short form merger brought about a fraud related to a "sale" of plaintiff's stock, even though she still physically possessed it. But see *Dasho* v. *Susquehanna Corp.*, 65 C 1757, N. D. Ill., June 28, 1966 (motion for rehearing), appeal pending, 7th Cir. We find no other case squarely in point, although *Ruckle* v. *Roto American Corp.*, 339 F. 2d 24 (2d Cir. 1964), and *Hooper* v. *Mountain States Sec. Corp.*, 282 F. 2d 195, 202-03 (5th Cir. 1960), cert. denied, 365 U. S. 814 (1961) ("otherwise dispose of"), both indicate receptivity on different facts to a broad construction of "sale" under the Act and Rule.[7] Although other cases are cited to us by appellees, none of them in fact is controlling.[8]

Under the particular circumstances of this case, we hold that appellant is a seller under the Act. Moreover the converse is, therefore, true; Beneficial, if the allegations

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7 See also *Polakoff* v. *Delaware Steeplechase & Race Ass'n*, 254 F. Supp. 574 (D. Del. 1966); *Simon* v. *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966); *Eagle* v. *Horvath*, 241 F. Supp. 341 (S. D. N. Y. 1965); *H. L. Green Co.* v. *Childree*, 185 F. Supp. 95 (S. D. N. Y. 1960); *Blau* v. *Hodgkinson*, 100 F. Supp. 361 (S. D. N. Y. 1951); Fleischer, *"Federal Corporation Law": An Assessment*, 78 Harv. L. Rev. 1146, 1153 n. 37 (1965); 3 Loss, Securities Regulation 1469-71 (2d ed. 1961).

8 *E.g.*, there was no deception in *O'Neill* v. *Maytag*, 339 F. 2d 764 (2d Cir. 1964); in *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (2d Cir.), cert. denied, 343 U. S. 956 (1952), plaintiffs had not sold their stock and were not being forced to; *Barnett* v. *Anaconda Co.*, 238 F. Supp. 766 (S. D. N. Y. 1965), involved lack of causality between the deception and the injury.

of the complaint are accepted, is a purchaser of plaintiff's stock through its agent and wholly-owned subsidiary Beneficial Finance Company of New York, Inc. The *amicus* brief points out that the fraud alleged here is properly regarded as in connection with the purchase of the Class A stock, rather than a sale, since the wrongdoing emanates from the purchaser. We accept this characterization and note that it does not change the substance of the legal right involved.

Appellee vigorously contends that appellant cannot be a defrauded seller because nothing was asked of him, no representations were made to him—indeed, under the merger statute, nothing had to be communicated to him but notice of his right to the offered $3.29 or to demand an appraisal. But it is precisely because appellee gives no choice to Vine under the statute and the latter must now exchange his shares for cash that appellant can now be deemed a seller. But appellee says, assuming that conclusion of the merger makes appellant a seller, any deception was in connection with the earlier stock acquisition from the ninety or ninety-five per cent of A stockholders, and that deception did not relate to appellant, who did not sell at that time. This ignores the simple fact that appellant would never be in the position of a forced seller were it not for the fraud. In essence, because of the distinctive nature of the short form merger procedure, appellee by deceiving A can cause B to become a seller. When this is all part of a single fraudulent scheme and that scheme is a classic example of deception of an entire class of Class A public stockholders, as alleged here, we think the policies of section 10(b) and Rule 10b-5 justify holding that fraud on A is "in connection with" the forced sale by B. Appellee's point really is that reliance is a requirement in a Rule 10b-5 action and that appellant

could not have relied on any deception because no representation was made to him. The need for such reliance by a plaintiff has been the subject of much recent scholarly analysis. See, *e.g.*, Painter, *Insider Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5,* 65 Colum. L. Rev. 1361, 1366-72 (1965); Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity,* 74 Yale L. J. 658, 667-74 (1964). Whatever need there may be to show reliance in other situations, see *List* v. *Fashion Park, Inc.,* 340 F. 2d 457, 462-64 (2d Cir.), cert. denied, 382 U. S. 811 (1965); *Rogen* v. *Ilikon Corp.,* 361 F. 2d 260, 266-68 (1st Cir. 1966), we regard it as unnecessary in the limited instance when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoer. Since the complaint alleges that plaintiff, in effect, has been forced to divest himself of his stock and this is what defendants conspired to do, reliance by plaintiff on the claimed deception need not be shown. What must be shown is that there was deception which misled Class A stockholders and that this was in fact the cause of plaintiff's claimed injury. The allegations of this complaint meet that test.

The district court pointed out that the New York statutory scheme for short form mergers preserves appellant's right to challenge the legality of the merger.[9] N. Y. Bus. Corp. Law §623(k). Appellee claims this to be a misreading of the law; however, we need not tarry over this for we do not regard the existence of a state remedy as negating the federal right. See *J. I. Case Co.* v. *Borak,* 377 U. S.

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9 This is the possible exception to the description of appellant's rights referred to at pp. 1540-41 *supra;* appellee does not agree with the district court in this respect, arguing that "a short form merger in its nature cannot be attached by a minority stockholder as fraudulent."

426, 433-35 (1964). Appellee also points out that the *amicus* Securities and Exchange Commission has previously advocated that mergers do not result in sales of stock by dissenters.[10] We note that whatever stance it adopted two decades ago, the Commission strongly urges in this case that the short form merger resulted in a purchase and sale of plaintiff's stock within the meaning of Rule 10b-5.[11] Indeed, the Commission advances the alternative argument that plaintiff need not even be a selling stockholder to sue under 10b-5, so long as the Rule has been violated and plaintiff's stock lost value as a result. The Commission claims in effect that prior decisions in this circuit,[12] often cited for the rule that only a seller or purchaser may bring a Rule 10b-5 action, have been too broadly read and can be distinguished, see Leech, *Transactions in Corporate Control,* 104 U. Pa. L. Rev. 725, 832-35 (1956). In view of our disposition of this case, it is unnecessary to deal with this interesting contention. Finally, appellee argues that appellant can show no injury because the complaint alleges that the interest of the 624,870 outstanding shares of Class A stock amounted to $1,670,000 or $2.67 a share, while non-selling A stockholders were offered a minimum of $3.29 a share. However, the damages alleged to A stockholders do not rest solely on the $1,670,000 figure, but also include the sum of $800,000; this amounts not to less than $3.29 per A share, but to more.[13]

* * * * *

10 Reference is made to an *amicus* brief of the Commission in *National Supply Co.* v. *Leland Stanford Junior University*, 134 F. 2d 689 (9th Cir.), cert. denied, 320 U. S. 773 (1943), which construed the Securities Act of 1933.

11 Moreover, in *SEC* v. *National Sec., Inc.*, 252 F. Supp. 623 (D. Ariz. 1966), the Commission attacked a consolidation and reorganization under Rule 10b-5.

12 *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (2d Cir.), cert. denied, 343 U. S. 956 (1952); *O'Neill* v. *Maytag*, 339 F. 2d 764 (2d Cir. 1964); *List* v. *Fashion Park, Inc.*, 340 F. 2d 457 (2d Cir.), cert. denied, 382 U. S. 811 (1965).

13 It should also be pointed out that if appellant states a federal claim —as we hold he does—he also purports to represent those selling A stockholders who accepted the $1.25 per share public offer of August 1963, or the $2.50 public offer of January 1965, all of whom may have been injured, if the allegations of the complaint are true.